

**REDACTED VERSION**

STATE OF MAINE  
PUBLIC UTILITIES COMMISSION

Docket No. 2003-914

August 17, 2004

MAINE NATURAL GAS CORPORATION  
Proposed Revisions to FPO and IPO  
Terms and Conditions

ORDER

WELCH, Chairman; DIAMOND and REISHUS, Commissioners

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**I. SUMMARY**

Based on a summary review, we find that Maine Natural Gas (MNG) is not overearning and, consequently, it is not necessary to conduct a full base rate case for MNG at this time.

**II. BACKGROUND**

In its April 16, 2004 Order in this docket, we found that a revenue requirement and earnings review of MNG's distribution rates is warranted at this time. We directed the parties<sup>1</sup> to find agreement on the form and detail of this review, cautioning that it should be done in a way that the burdens of the proceeding do not overwhelm the benefits of such a review.

In response to this directive, MNG filed basic earnings and revenue requirements information on June 8, 2004, following discussions with OPA and Advisory Staff on the form and content of this filing. The OPA and the Advisory Staff each filed data requests to which MNG responded on June 30 and July 1, 2004. At a technical conference on June 29, 2004, parties explored the substance of the MNG filing and set a schedule for an Examiner's Report, exceptions and deliberations. At that conference, neither MNG nor the OPA recommended that we take any further action at this time.

**III. DISCUSSION**

Based on the information provided by MNG and the technical conferences, we have considered three questions:

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<sup>1</sup> The Office of the Public Advocate, Bangor Gas, and MNG are the parties in this Docket.

- 1) Using calendar 2003 as an historic test year, is it likely that MNG would be earning more in calendar year 2004 than its revenue requirements and therefore that a rate reduction was warranted?
- 2) Should the fact that MNG is still a startup utility affect our decision concerning whether MNG will overearn during calendar year 2004?
- 3) MNG serves some customers under its PUC approved tariffs and other customers under various negotiated service contracts. The Commission allowed MNG to enter into negotiated contracts at its shareholders' risk. Could one plausibly conclude that MNG's regulated rates are unreasonably high, but that these profits are offset by losses on the negotiated contracts?

A. Analysis of 2003 Revenue Adequacy

In its June 8 filing, MNG analyzed its cost of service based on actual 2003 revenues and expenses. In the filing, MNG represents that its book 2003 revenue requirements, excluding any cost of debt or equity capital, were about \$6.3 million and its actual revenues from current rates was \$5.1 million. Combined, these produce a revenue shortfall of \$1.2 million or about 24%. MNG used an estimated rate base and a presumed capital structure of 50% debt at a 7% interest rate and 50% equity at 12% cost of equity (COE) to suggest that its actual revenue requirement is about \$9.0 million, or about 175% of its actual 2003 revenue.

Although a detailed analysis of MNG's calculation of 2003 revenue requirements might produce a lower revenue requirement, we are persuaded that for 2003, MNG did not earn a reasonable rate of return. In fact, MNG's revenues were less than its operating expenses, including the costs of gas,<sup>2</sup> to say nothing of depreciation expense, property taxes, or other expense items.

Based on this review, it appears unlikely that a more detailed review of MNG's revenue requirements based on the most recent historic test year would indicate that its rates are too high.

B. Likelihood of Overearnings in 2004

One could argue that, even though MNG suffered a loss in 2003, it is a growing company and that sales and revenues could rise more quickly than expenses. If revenues rise fast enough, in principle, it is possible that in 2004 MNG will overearn and that rates may be too high. To evaluate the likelihood of this possibility, we looked to its confidential 2004 budget information that MNG provided as part of its June 9 filing.

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<sup>2</sup> During 2003, MNG was at risk for certain gas costs. This changed with our April 16, 2004 Order in Docket No. 2003-914 that allowed reconciliation of gas costs. However, pro forming this change in the treatment of gas costs into the 2003 results does not affect our conclusions.

This is the same budget that MNG prepared and corporate management approved late in 2003.

Because the budget information is confidential, and for reasons of administrative convenience, the analysis of that information is contained in Confidential Appendix A to this Order. From that analysis, we conclude that there is no reasonable likelihood that MNG's current rates will prove too high based on a 2004 test year.

C. Are Tariffed Rates Too High and Negotiated Rates Too Low?

We must also consider whether MNG's regulated rates might be unreasonably high, but that these profits are offset by losses on the negotiated contracts. In our order adopting MNG's original rate plan, we stated:

We will allow CMP Natural Gas [now Maine Natural Gas] to enter into special rate contracts without prior Commission review and approval, but we do not guarantee recovery of foregone revenue from other ratepayers. ... If and when CMP Natural Gas seeks rate changes upon the expiration of its rate plan, we can address the question of whether tariffed rate customers should be required to make up for discounted prices to special contract customers. . . .  
...

...At the time of the next general rate proceeding, we will scrutinize special contracts very carefully to avoid any possibility of subsidization.

Docket No. 96-786, Order (Dec. 17, 1998) at 12.

There are several approaches one might take to determine whether there is a substantial subsidy flowing from tariffed rate customers to special contract customers. The simplest approach, at least conceptually, is to allocate MNG's revenues, expenses, and rate base among the various customer groups.<sup>3</sup> For purposes of this review, we used a simplified cost allocation approach in which we made a conscious effort to resolve any potential points of controversy in favor of the tariffed rate customers. We do so on the theory that if we can conclude that tariffed rate customers are being charged reasonably for service under the assumptions most favorable to them, then we can fairly conclude that they would not be found to be overcharged under assumptions that are less favorable to them.

This analysis was based on MNG's 2004 budget, since the revenue deficiency for the budget year is lower than for the test year. We divided the customers

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<sup>3</sup> This approach is commonly referred to as the embedded or accounting cost approach and is, in essence, a mechanism to consider the average costs of each customer group.

into three groups, the tariffed rate customers, including both residential and non-residential, Calpine, a very large special contract customer, and all other special contract customers excluding Calpine. We treated Calpine separately because it is so large relative to the rest of the customers and because the portion of the MNG facilities it uses are largely dedicated to its sole use at this time. A substantial majority of MNG's throughput goes to Calpine.

The results of this analysis are shown in Confidential Appendix B. In our analysis, we assigned to tariffed rate customers the lowest costs of distribution service in all cost categories. Among the major assumptions were that depreciation and interest expense were allocated in proportion to each customer groups' share of net plant. In addition, we assumed that all operations and maintenance expenses, the largest group of expenses after gas costs, should be allocated in proportion to throughput. As a result, tariffed rate customers are assigned just over 1% of O&M costs. For purposes of this analysis we also divided "other expenses," which are primarily marketing costs, between tariffed rate customers and special contract customers, excluding Calpine on the theory that little or no marketing occurs.

As shown in Confidential Appendix B, this analysis suggests that MNG is earning approximately a 1% rate of return in serving tariffed rate customers. In reality, the actual earnings rate for tariffed rate customers is probably lower, since the analysis is intentionally skewed in their favor. Thus, we conclude that there is no need to reduce tariffed rates and that tariffed rate customers are not currently subsidizing other customers.

D. Future Rate Filings for Maine Natural Gas

We do not need to open a more detailed review of MNG's rates at this time. In fact, the information we have reviewed could be read to suggest that MNG is not earning a reasonable rate of return. MNG has made informal statements that it may seek a rate increase within a year or so. If so, this will be the first rate case for a new gas LDC following the expiration of an initial rate plan. Thus, it may be useful for us to reiterate some of our statements in prior decisions.

Ultimately, a rate case considers two questions, what is a reasonable revenue requirement for a utility's customers to bear and how should individual class rates be set in order to provide a reasonable opportunity to recover those revenues. Resolving each of these issues will require answering some novel questions which were raised, but not resolved, in our December 17, 1998 Order approving the rate plan. Regarding distribution cost recovery, we stated:

CMP Natural Gas proposes to freeze base distribution rates for 5 years beginning December 1, 1998. Because of the length of time projected to build the distribution system out to a level where it can sustain itself, we consider five years the minimum term for this startup entity. The shortness of the

term may result in difficult questions regarding the allocation or risks to investors versus ratepayers if the Company seeks a base distribution increase for the sixth year. Nevertheless, the proposal does ensure a period of partial rate stability and appropriately places the early startup investment burden on shareholders. While we might prefer a longer, more comprehensive rate stability mechanism, this proposal offers something of value. Thus, we accept the 5-year base distribution rate freeze term.

Docket No. 96-786, Order Approving Rate Plan (Dec. 17, 1998) at 4.

In other words, a request for a rate increase would require us to address the issue of whether that revenue requirement should be fully borne by customers.

There also remains the issue of cost assignment between tariffed customers and special contract customers. Regarding special contracts, the Order points to issues that must be taken into consideration in MNG's first rate proceeding, as follows:

We will allow CMP Natural Gas to enter into special rate contracts without prior approval, but we do not guarantee recovery of foregone revenues from other ratepayers. This is consistent with our policy of placing start-up business risk on shareholders and with CMP Natural Gas's expectation. If and when CMP Natural Gas seeks rate changes upon the expiration of its rate plan, we can address the question of whether tariffed rate customers should be required to contribute more to make up for discounted prices to special contract customers.

Docket No. 96-786, Order Approving Rate Plan (Dec. 17, 1998) at 12.

The Order continues, as follows:

In the meantime, we will require CMP Natural Gas to file in this docket for informational purposes any special contracts it enters into with customers. When a special contract is filed, the Company should indicate its view of the relationship of the contract price to short-run marginal cost, and, if the contract rate is lower than short-run marginal cost, to indicate why, in its view, it is prudent to enter into the contract. We will not review and approve each contract, reserving the question of specific ratemaking treatment for a rate case. At the time of the next general rate proceeding,

we will scrutinize special contracts very carefully to avoid any possibility of subsidization.

Docket No. 96-786, Order Approving Rate Plan (Dec. 17, 1998) at 12-13.

We note with some concern, however, that in this proceeding MNG stated that it has not attempted to separate costs for distribution service used by its tariffed rate customers and from that used by special contract customers. Had the earnings picture been less clear, we would have been required to conduct an analysis of the cost separation between tariffed rate customers and special contract customers. Moreover, although in its cover letters accompanying its special contract filings MNG has consistently stated "its view" that the contract price for each of the contracts exceeds the company's short run marginal cost, the Company has provided no accompanying analysis.<sup>4</sup> Consequently, the Commission has received no information to date with which to evaluate this question.

Since we need not reach these questions in the case before us, they are currently more theoretical than real. We point them out here simply to flag them for the Company and other parties in a possible future rate case.

Dated at Augusta, Maine, this 17<sup>th</sup> day of August, 2004.

BY ORDER OF THE COMMISSION

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Raymond J. Robichaud  
Acting Administrative Director

COMMISSIONERS VOTING FOR:      Diamond  
   Reishus

COMMISSIONER ABSENT:              Welch

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<sup>4</sup> Our Order Adopting Rate Plan in Docket No. 96-786 effectively suggests short run marginal costs as a floor on special contract rates. We note, however, that it explicitly reserved the question of the ratemaking for special contracts that meet that floor, leaving open the question as to what portion of total revenue requirement tariffed rate customers should bear. *Central Maine Power Company, Request for Approval to Furnish Gas Service in and to Areas not Currently Receiving Natural Gas Service*, Docket No. 96-786.

## NOTICE OF RIGHTS TO REVIEW OR APPEAL

5 M.R.S.A. § 9061 requires the Public Utilities Commission to give each party to an adjudicatory proceeding written notice of the party's rights to review or appeal of its decision made at the conclusion of the adjudicatory proceeding. The methods of review or appeal of PUC decisions at the conclusion of an adjudicatory proceeding are as follows:

1. Reconsideration of the Commission's Order may be requested under Section 1004 of the Commission's Rules of Practice and Procedure (65-407 C.M.R.110) within 20 days of the date of the Order by filing a petition with the Commission stating the grounds upon which reconsideration is sought.
2. Appeal of a final decision of the Commission may be taken to the Law Court by filing, within **21 days** of the date of the Order, a Notice of Appeal with the Administrative Director of the Commission, pursuant to 35-A M.R.S.A. § 1320(1)-(4) and the Maine Rules of Appellate Procedure.
3. Additional court review of constitutional issues or issues involving the justness or reasonableness of rates may be had by the filing of an appeal with the Law Court, pursuant to 35-A M.R.S.A. § 1320(5).

Note: The attachment of this Notice to a document does not indicate the Commission's view that the particular document may be subject to review or appeal. Similarly, the failure of the Commission to attach a copy of this Notice to a document does not indicate the Commission's view that the document is not subject to review or appeal.